Investing in Emerging and Frontier Economies

How Blended Finance can make the most of public funding

ILN Position Paper for COP26 and G20, in collaboration with The Rockefeller Foundation

INVESTOR LEADERSHIP NETWORK

The ROCKEFELLER FOUNDATION

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EXECUTIVE SUMMARY

Combating climate change and achieving the SDGs require vast investment in sustainable projects in developing countries, but the world is falling short.

A crucial reason is that a rich source of funds is not being fully tapped in to: the private sector, which is eager to gsignificantly increase its sustainable investments, but is constrained by avoidable obstacles.

Private investors face an unattractive risk-return nexus; they lack easy access to crucial information: e.g. which projects the public sector is planning that they could take part in, and what they entail.

Exposure to the risks of investing in less mature markets, with insufficient insurance available, deters them as well.

In this report, the Investor Leadership Network (ILN), whose members manage over USD 9 trillion of investments, offers solutions.

It calls for better collaboration between public and private sectors to make blended finance (public/private investment partnerships) a driving force in this area.

Compiled with the support of The Rockefeller Foundation, the report calls for a sea change in how multilateral development banks (MDBs), governments, foundations, and other public institutions see private-sector involvement.

The ILN makes specific proposals it calls credible, implementable and effective, and these include:

- Creating a rolling pool of funds offering first- or second-loss guarantees so the private sector can cover currently hard-to-insure risks such as those relating to regulatory changes, taxation, and reputational risk;
- Creating a separate facility to help with one of the biggest obstacles, foreign exchange risk;
- Creating a detailed shared database of projects that MDBs are screening so that private investors can express an interest early on;
- Setting up a searchable virtual toolbox so investors can more easily find the plethora of currently little-known risk-hedging instruments that MDBs and philanthropic organizations offer;
- Giving the private sector full access to the Emerging Markets Risk Database or similar information to help assess risks;
- Expanding an ILN fellowship program to help emerging-market government officials understand institutional investors' needs and network with potential investors;
- Hosting philanthropic and financial-market participants at The Rockefeller Foundation's Bellagio Center to

INTRODUCTION

As countries move to combat climate change, significant investments in sustainable infrastructure are needed, especially in emerging and frontier economies.

Public-sector resources, however, are constrained. According to the United Nations, an investment funding gap of well over USD 500 billion per annum for climate change solutions in such economies is projected for the next ten years.

Private investors, particularly large institutional investors, have the financial resources – many times larger than those of the public sector – as well as the expertise to allow them to increase sustainable investments in emerging and frontier economies. But they have not done so to the extent required. Why?

Institutional investors cite several limiting factors, including the availability of investable projects, institutional constraints, high-risk premiums, and macro-economic and foreign-exchange related factors, all leading to an unfavorable risk-return nexus.

Blended finance – the use of capital from public or philanthropic sources to "catalyze" private sector investment in developing countries – is widely recognized as an effective way to improve the risk-return profile and help mobilize significant private-sector funding.

This paper discusses the impediments to sustainable finance in emerging and frontier economies (although many of the challenges also apply to advanced economies), and proposes measures to reduce these obstacles and ameliorate risks:

- It highlights how the official sector (i.e. providers of public funding), including multilateral development banks (MDBs), and also the philanthropic sector can partner with the private sector to implement measures and boost capital flows.
- It explores sequencing aspects: speedier actions likely to yield important early results in unlocking private flows, and then longer-term actions that should nevertheless be initiated now to drive additional funding in the medium term.
- It provides proposals for closer interaction between philanthropic organizations and the private sector, and recommends measures to obtain greater access to specific data sources so that the private sector can better assess risks.

The proposals complement those being made by other organizations and groups such as the Sustainable Markets Initiative (SMI) and Global Investors for Sustainable Development alliance (GISD) regarding investments for climate change solutions and the global economic recovery from the COVID-19 pandemic. The paper provides specific recommendations, tools and implementable instruments, as well as a timeline, for facilitating a partnership between private institutional capital and the public sector.

It also provides illustrative indications of the capital flows that can occur if the requisite actions are undertaken over the near- and medium-term using blended finance as a catalyst to leverage public funding. These proposals would speed up sustainable investments in the developing world, facilitate the recovery of the global economy from the pandemic and sustain future growth.

The paper represents the collective views of the Investor Leadership Network (ILN) with aggregate assets under management exceeding USD 9 trillion. The proposals highlight the aim of the ILN membership to seek ways to markedly increase sustainable private-sector investments alongside those of the official and philanthropic sectors.

Following this introduction, Section 2 discusses the main impediments and risks; Section 3 summarizes the types of instruments needed to deal with the risks; Section 4 discusses specific suggested instruments and measures; Section 5 notes the areas of cooperation between the official and the private sector, and the size of flows to emerging and frontier economies that these proposals could bring; and Section 6 notes a possible timeline and concludes.

IMPEDIMENTS

There are several interrelated impediments or risks that have constrained private-sector investments, especially by private institutions, across a broad range of asset classes, but particularly in sustainable infrastructure, private debt and private equity investments in emerging and frontier economies.

Some of these factors such as macro-economic conditions are difficult to structure for and can therefore be challenging to turn around in the near or medium term, while others, like the pipeline of bankable projects, scalability and implementation capability, can be solved more quickly.

General challenges to investing in emerging and frontier markets include the size and growth potential of the economy, macro-economic stability (e.g. inflation, fiscal deficits), institutions, regulatory environment, openness of the external capital account, adequate liquidity, and strength of governance.

One of the most important elements in this category is foreign exchange (FX) risks, including volatility of the exchange rate, the availability and cost of hedging instruments, and repatriation aspects.

A second set of considerations relates to the availability of investable projects. The low number of potential projects poses an initial challenge that is often amplified by the fixed costs involved in developing projects. Large private investors' needs and the funds at their disposal, the size of potential deals, and their replicability are also important considerations.

Thirdly, there are elements arising from deal execution, structuring and portfolio management. Impediments arising from these factors reflect issues regarding the institutional and legal framework, governance (including concerns about corruption) and inadequate track record.

Beyond market- and deal-level impediments, blended finance typically involves different types of investors with differing goals and constraints. Accommodating them all can itself be challenging.

All of these impediments can culminate in private investors' perception that the returns from investing in emerging and frontier economies are not worth the real or perceived high level of risk. The largest barrier to capital flow in emerging and frontier economies is that they are largely viewed as unattractive markets.

OVERVIEW OF MEASURES TO REDUCE THE RISKS

At the economy-wide level, macro policies need to be adopted that address the areas noted in Section 2. MDBs can continue to play an important role in this regard by providing the right incentives and advising governments to pursue policies that facilitate institutional investment.

At the economy-wide level, macro policies need to be implemented that address the areas noted in Section 2. International financial institutions including MDBs can play an essential role in this regard by providing the right incentives and advising governments to pursue policies that facilitate institutional investment.

More importantly, MDBs and the public sector can more actively involve the private sector. MDBs should help create an environment for the private sector to invest and be a partner, and even take the lead in designing and structuring blended-finance instruments in close cooperation with the private sector.

MDBs have vast institutional knowledge and operating capacity in many emerging and frontier economies, but this expertise could have more impact on the mobilization of capital if these banks were regarded by everyone as an equal partner to the private sector (as recent reports suggest that they utilize only 45 percent of their capital). For this to be successful, a mindset shift around the role of MDBs would need to occur over the medium-term among all stakeholders, including the G7 and G20, development finance institutions (DFIs), MDBs and the private sector itself.

Regarding specific policies, MDBs should significantly increase their efforts to systematically develop pipelines of projects across a whole range of industries, sectors, and countries. This would likely entail a material reorientation of official resources to developing the pipelines, country support to build counterparty capacity, and Technical Assistance (TA) vehicles as part of investment platforms.

It could also involve non-traditional platforms and actors (e.g. philanthropic organizations) to develop deals particularly in frontier markets.

This shift has started to occur, for example with the International Finance Corporation ramping up its project development capacity significantly through its IFC Ventures program. These are important first steps and the ILN would like to help ensure that projects developed by the official sector have private capital mobilization at the heart of their objectives.

Beyond creating such pipelines, it is critical to develop or augment specific instruments to reduce risk and/or to improve returns, bringing the risk-return nexus in line with donor requirements.

Reducing risks could take several forms, including:

- instituting a pool of funds to:
  - provide and scale guarantees;
  - provide a first-loss facility;
- offering Technical Assistance and advisory services;
- limiting downside-loss exposure;
- improving creditworthiness;
- eliminating funding shortfalls.

Enhancing returns could include:

- measures to improve the attractiveness of returns;
- result-based financing for successful performance outcomes;
- providing additional financial assistance where appropriate.

Multilateral development banks could also do much more to help develop, operate and monitor carbon markets including emissions-trading systems and offsetting mechanisms in emerging and frontier economies.

The extent of risk mitigation depends on investor type and jurisdiction. Blended finance creates specific issues with reconciling the risk-adjusted return objectives of different agents. While there are certainly some general impediments (as noted above) and solutions, risks and instruments often need to be deal-specific.

We must recognize the range of risks that private investors are simply unable or unwilling to take on, and explore what can be done to mitigate them. The risks linked to any project need to be more transparent and discussed with investors at the earliest stages of the process. We need to educate the private sector and raise comfort levels -- for instance, by providing more data and track records from past transactions and from the emerging market investing environment, and by sharing MDBs' expertise.

When looking at specific projects, blended-finance instruments should be used to mitigate only those risks that institutional investors are not prepared to take, and they should be used with long-term sustainability as a key element. This ensures that risk-adjusted returns are optimized.

When developing a platform/portfolio structure of emerging market investments, blended finance can be used to provide first-loss tranches, cover specific risks, and extend leverage at concessional rates. This will help optimize the risk-adjusted return of a pool of investments, thus making them attractive to institutional investors while remaining competitive in pricing for each individual portfolio borrower.

SPECIFIC INSTRUMENTS

A. Short to medium run (implementable between three to six months):

(i) Create a database that includes projects which MDBs are screening

The ILN recommends building a shared database to collate high-level information about MDB projects that the official sector and MDBs are considering, providing private institutional investors access to this inventory and allowing them to express interest at an early stage. Key information hosted on the database could include sector, country, total project cost, any sponsor and EPC (engineering, procurement and construction) contractor, any information related to the project contract(s), and key contacts in charge of the project.

The database should download that information automatically from the MDBs' systems at a predetermined frequency (for instance, weekly).

This proposal complements recent statements from the Sustainable Markets Initiative calling for the development of project pipelines and highlighting the importance of transparent dissemination of the requisite information.

At the same time, the private sector can be encouraged to engage with the public sector and MDBs early on as opportunities arise and to be involved in developing the database.

(ii) Create a virtual toolbox to group all risk mitigants

MDBs and philanthropic organizations currently offer a plethora of de-risking instruments with varying forms, scope, and degrees of effectiveness. Because there are many MDBs and philanthropic organizations, most of their offerings are not well known, so they remain inaccessible to institutional investors.

Our suggested virtual toolbox would gather all these instruments in one place, categorize them by searchable descriptions of their purpose, provide step-by-step explanations on how they are structured and function, and list their relevant MDB contacts. Each instrument's description would also indicate the steps and length of time it takes to close a deal.

Further, it would help if the private sector had unfettered access to the Emerging Markets Risk Database known as GEMs, or similar information so investors can better analyse and assess risks. This database — one of the world's largest credit risk databases — is used extensively by the GEMs consortium institutions that include MDBs and development finance institutions.

B. Longer-term tools to structuring projects that are bankable or investable (six months to two years):

(i) Provide or enhance guarantees/insurance

Various guarantees and insurances are available, some managed by MDBs, some by national governments or other cross-national agencies. Two main types are:

- Political-risk insurance which covers project-specific risks including war, expropriation, restriction of transfers and currency inconvertibility, and breach of contract.
- Contract-frustration insurance/non-honoring policies that cover defaults of borrower obligations under a credit agreement.

Such instruments can be helpful tools when structuring transactions, but they lack the flexibility required to respond to the unique needs of institutional investors, whose aim is to optimize the risk-return balance of their investments within the constraints of their mandates.

These instruments also leave many risks partially or wholly unaccounted for, including those relating to regulatory changes, macro policies, taxation, governance, reputational risk, etc.

To deal with these risks, we propose creating a rolling pool of funds that can provide a "menu" of first-loss or second-loss guarantees. Investors may consider paying a small premium to obtain access to the pool, above a certain amount. The speed with which investors can obtain access and the transparency of the pool's operations will be critical. One possible source of funding could be the resources provided by the SDR (special drawing rights) allocation, recycled by members of G7/G20.

Further, institutions could engage in a variety of "demonstration deals" with relevant partners to deploy capital with bespoke guarantees.

We propose the following which could draw on a guarantee pool:

- A wider array of guarantee/insurance products: Recognizing that no single deal is identical, a wider array of specific project risk insurance should be made available to investors in cases where such risk mitigants may not be available within the existing contractual structure of transactions. These may include for instance reputational risk insurance, as well as Environmental, Social and Governance risk insurance, and FX risk insurance.
- Investor-centric pricing: Insurance pricing should be based on the perspective of the investor and aim to engineer de-risked returns that remain attractive on a risk-adjusted basis. Currently, the guarantee and insurance markets do not incorporate adequate liquidity and complexity risk premiums into their pricing mechanisms. Adding these premiums to an investor's final return would entice institutional investors to substitute highly rated liquid fixed-income assets for illiquid guaranteed products that offer a premium for the same level of risk.
- Faster turnaround: turnaround times for providing such guarantees should be quick enough to meet both institutional investors' and borrowers' needs.

(ii) Foreign exchange-related risks

A key major specific risk relates to foreign exchange. Emerging-market currencies can be very volatile and valuations can diverge from fundamentals for long periods.

These risks are significant in infrastructure investments, but also in other investments conducted in local currencies. This risk has often been one of the key inhibiting factors for private capital in these markets. Insurance can be obtained from these markets, but it is often only for a short term, limited to a few countries, and can be very expensive.

We propose a facility to provide guarantees against FX risks and complement the aforementioned "guarantee pool". An illustration is provided by Guarantco, a facility that makes guarantees in frontier markets and covers a wide array of non-payment risks. This facility could again be provided by MDBs in conjunction with G7 governments to streamline implementation and blending with other investment pools.

(iii) Enhance the ILN Sustainable Infrastructure Fellowship Program

The ILN has funded and run its Sustainable Infrastructure Fellowship Program (SIFP) since 2019 for senior government officials in emerging markets to promote a mutual understanding of the requirements for capital investment between the officials and private investors. Launched in co-operation with a Canadian university, this program delivers training and insights into the private sector investment decisions through the presentation of case studies, panel discussion and simulation supported by ILN investment experts.

By better aligning the expectations of infrastructure planners and investors, SIFP seeks to help emerging-market leaders learn how to develop sustainable, investment-ready infrastructure projects, and show them the criteria institutional investors use to evaluate investments.

To date, two successful cohorts have graduated from the program -- 13 Fellows from eight countries in 2019, and 21 Fellows from 17 countries in 2021. The Fellows continue to share information and knowledge with one another. Creating a shared understanding of investors' criteria and best practices in infrastructure planning is a significant benefit of the program in addition to the education received.

We propose to raise the program's influence by expanding the cohort size; increasing emerging-market and investor-based content; and adding delivery hubs around the world. These activities are likely to make institutional investors more able and willing to undertake sustainable investments and make blended-finance projects more likely.

COOPERATION BETWEEN PRIVATE, PHILANTHROPIC, AND OFFICIAL SECTORS AND THE IMPACT ON FLOWS

Flows from the official sector have been significant, and those from the private sector have risen markedly.

But private investments could have been several times larger over the last decade had the right environment been in place. Should the proposals noted above be adopted, private institutional investors could unlock large potential flows.

While it is difficult to provide a counterfactual given the range of factors involved, tentative estimates suggest that were the risk-return nexus to improve materially, flows to emerging and frontier economies for sustainable investments could increase considerably: as much as 50 percent or more over the next two to three years; and plausibly by over 100 percent over the next three to five years, compared to the last five years.

Such a rise would help plug the gap that exists between the investments needed for sustainability, and those that appear to be forthcoming from the private and the official sector.

Blended-finance partnerships can make a material difference in dealing with investment challenges in emerging and frontier economies.

Philanthropic organizations also have an extremely important role to play, complementing the actions of the official and the private sector. The vast financial resources at their disposal have risen almost fivefold over the last 15 years or so. Institutions like The Rockefeller Foundation have recently issued their own bonds in the market in an effort to scale the levels of their philanthropic funding, given the gravity of the challenges the world faces. These institutions' leadership in incubating and growing the field of 'impact investing' has provided important in-roads with the private sector that can be built on.

Crucially, philanthropic funding can typically move more nimbly and flexibly than the public sector's, so discrete risks can be addressed in a variety of ways.

Philanthropic institutions can be important sources of concessional funding and can provide discrete risk-mitigation instruments to complement official-sector activities and catalyze the private sector.

They can be important, full partners for the private and official sectors, complementing measures that the official sector can take to improve the risk-return nexus while directly engaging private-sector partners.

To deepen collaboration between philanthropic and financial market participants, we propose a convening at The Rockefeller Foundation's Bellagio Center to identify discrete areas of partnership and collaboration between the official, private, and philanthropic sectors. The aim is to accelerate progress and increase meaningful investments in emerging and frontier economies.

More generally, it would be helpful to bring stakeholders together at the country level to identify potential project pipelines, challenges and needed reforms (as modeled by Country Mobilization Platforms in support of climate action). Such meetings might not be as straightforward due to the differing objectives and constraints of the various parties, but they would be essential in identifying constructive action toward structuring blended-finance platforms with both private and public sector-led projects.

CONCLUSIONS

The magnitude of climate change and sustainability challenges means that the resources needed far exceed the capacity of the official sector – including national governments, MDBs, and DFIs – especially in emerging and frontier economies. However, with the right environment and with specific policies implemented to facilitate private investment, these resources can come from the private sector.

A regime shift in the way private sector involvement is seen by the official sector and MDBs is urgently needed.

The proposals and recommendations of this paper are credible, implementable, and effective. The private sector is ready to markedly increase its commitments in the near and medium term.

If implemented in the correct sequence and urgently, these measures can lead to a sea change in the private sector's involvement in sustainable investments in emerging and frontier economies in the medium-term – and also in advanced economies.

The agenda and the proposals discussed in this paper can be advanced significantly by working in tandem with the SMI, GISD, MDBs, and philanthropic organizations.

The G7/G20 must urgently commit to and support efforts to change attitudes about the operations of MDBs and the role of the public sector, to implement the proposed solutions to deal with the risk-return nexus, and to implement these measures in the right order. Were this to occur, there would be a major increase in resources flowing to emerging and frontier economies, providing huge sustainability dividends and meeting the existential challenges confronting the world.

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